

**Management Advisory Report: Existing
Compliance Function Processes Were
Transferred Into the New
Small Business/Self-Employed Division**

May 2001

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

May 11, 2001

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Management Advisory Report - Existing Compliance
Function Processes Were Transferred Into the New
Small Business/Self-Employed Division

This report presents the results of our analysis of the Small Business/Self-Employed (SB/SE) Division's efforts to smoothly transfer compliance processes from the old District-based organization to the new SB/SE Division structure. This report is being provided to aid Internal Revenue Service (IRS) management in its efforts to modernize the IRS.

In summary, management generally took effective steps to ensure the smooth transition of work processes and responsibilities to the SB/SE Division's new Compliance function from the former District Examination and Collection functions. However, SB/SE Division management attention is needed to improve case inventory controls. We provided the field offices the results of our analyses for possible corrections and adjustments to the applicable case inventory control systems during our review.

Since we are making no recommendations, a response to this report is not required. Copies of this report are also being sent to the IRS managers affected by the report.

Please contact me at (202) 622-6510 if you have questions, or Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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Objective and Scope

The objective of our review was to determine whether SB/SE Division management met its goal of smoothly transferring the former IRS District Examination and Collection functions into its new organizational structure.

The objective of our review was to determine whether Small Business/Self-Employed (SB/SE) Division management met its goal of smoothly transferring the former Internal Revenue Service (IRS) District Examination and Collection functions into the new SB/SE Division Compliance function.

We determined whether plans had been established to ensure numerous Examination and Collection function controls were addressed during the transition. These items included statute controls, case transfers, quality review sampling, and inventory perfection and validation.

We interviewed National Headquarters and field personnel in the SB/SE Division. We also performed substantive testing of 24 Examination and Collection function employee inventories by cross-matching case files to function-based management information systems that provide data to the IRS Masterfile. We randomly selected 2 employees from each of the 12 Examination and Collection groups within the 3 Compliance areas selected for review. The management information systems reports we analyzed included the Audit Information Management System (AIMS), the Examination Returns Control System (ERCS), the Integrated Collection System (ICS), Entity, and the Integrated Data Retrieval System (IDRS). We also analyzed inventory-related error reports generated during November and December 2000 from the ERCS and the ICS to identify discrepancies pre-dating the SB/SE Division transition.

This review was conducted at the SB/SE Division Headquarters in Washington, DC, and in selected offices of the SB/SE Division's Compliance Areas 2, 6, and 13. These Areas substantially covered the following seven former districts: Manhattan, Brooklyn, Michigan, Ohio, Kentucky/Tennessee, Northern California, and Central California. Fieldwork was conducted from October

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2000 through March 2001 in accordance with the President's Council on Integrity and Efficiency's *Quality Standards for Inspections*.

Major contributors to this report are listed in Appendix I. Appendix II contains the Report Distribution List. Appendix III contains a glossary of terms used in this report.

Background

The Compliance function of the new SB/SE Division conducts traditional post-filing Examination and Collection work.

The modernized IRS is comprised of four new operating divisions. One of the divisions is the SB/SE Division; it serves the 45 million fully or partially self-employed taxpaying individuals and small businesses with assets up to \$5 million. Employees in the Compliance function of the SB/SE Division examine tax returns and collect taxes owed by taxpayers. As part of the reorganization, employees in the former IRS district offices were placed in the SB/SE Division's new Area and Territory Offices.

To prepare for the implementation of the new SB/SE Division, local transition teams from each of the former district offices were tasked with standing down the old organization in their respective offices. The three main objectives of the stand-down were to:

- Keep the current organization running smoothly until stand-up occurred.
- Transfer people, processes, and systems to the new organization.
- Close down discontinued operations.

To achieve these objectives, the teams assigned tasks to local personnel and monitored their progress to ensure completion by October 1, 2000. These teams also coordinated with the new SB/SE Division to stand up the new organization and to achieve the common goal of smoothly transferring responsibilities. Some of the significant transition issues included case transfers between intra-organizational and external functions,

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quality review sampling, and inventory perfection and validation.

Results

The SB/SE Division generally met its challenge of moving basic Examination and Collection processes into the new organization. However, inventory concerns, especially the validation and perfection of inventories moving to the new organizational structure, still need to be addressed.

The transition process did not materially affect the continuity of SB/SE Division field Examination and Collection operations. Many transition activities were effectively implemented, however, inventory controls could be improved, particularly the validation and perfection of case inventories. We identified inventory mismatches pre-dating the SB/SE Division transition in both the Examination and Collection functions. Some of the validation issues were not necessarily transition issues. However, the reorganization complicated the validation process because Examination and Collection function employees now report to a Compliance Area Director, while support employees work for other executives located in different offices.

Field Operations Processes Were Not Significantly Affected by the Transition

The transition process did not significantly affect basic SB/SE Division field Examination and Collection processes. The IRS developed Transition Templates to help ensure basic business processes were carried forward into the new organizational structure. We verified that the following processes were carried forward; however, we did not assess the effectiveness of these controls or procedures:

- Statute controls are used to ensure that tax assessments and collections are made within legally established time periods.
- Case transfer procedures are used to re-assign cases from one employee to another.

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- Sampling techniques are used to select cases for the Collection and Examination Quality Measurement Systems.

Examination Inventory Validations Were Inconsistent or Incomplete

The Internal Revenue Manual (IRM)¹ requires periodic matching of taxpayer returns assigned to Examination employees. These returns should be physically matched to both the AIMS listing and the ERCS. Mismatches resulting from comparing these three data sources should be researched and reconciled. Other tools such as the ERCS Dropped AIMS Record Report should be used to perfect inventories. The SB/SE Division stand-up Transition Template required stand-down teams to ensure that the inventories were validated for each Examination function employee transferring to the new SB/SE Division.

Former district management did not always complete validations as required. Out of seven former districts reviewed: one district did not complete any validation at the time of stand-up, two districts compared the returns to the ERCS but not to the AIMS, and one district compared the ERCS to the AIMS but not to the returns.

Furthermore, the ERCS Dropped AIMS Record Reports prepared in November and December 2000 contained 234 mismatches involving items noted as started or in open Examination status. Many of the returns had been on the listing for some time:

- Fourteen mismatches (6 percent) were reported as occurring on the listing prior to January 1999.
- Seventy mismatches (30 percent) were reported as occurring on the listing between January and December 1999.

As of June 2000, 234 unresolved mismatches involving started or open Examination cases have been reported in ERCS Dropped AIMS Record Reports. Thirty percent of these mismatches were reported between January and December 1999, and six percent were reported during or prior to 1998.

¹ IRM Handbook 114.1 - SubSection 3.5.7.

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- One hundred and fifty mismatches (64 percent) were reported as occurring on the listing between January and June 2000.

If validations are conducted properly and error reports worked timely, these types of errors would be resolved more quickly.

Some managers did not conduct complete validations because they believed inventory validations were unnecessary, given that many of their employees were not affected by the organizational realignment and simply retained their return inventories. In addition, Examination function managers and stand-down teams could have made better use of the resources available to them from former district coordinators of the AIMS and the ERCS, including the routine error and mismatch reports.

Mismatches involving missing taxpayer returns can negatively affect taxpayer rights, since the examinations could be delayed and additional interest assessed if more tax is due. Mismatches can also distort case-related management information data used by new organizational managers.

During our review, we informally provided the results of our ERCS Dropped AIMS Record Report analysis and employee inventory matches to applicable Examination function managers to assist them in resolving these mismatches.

Collection Inventory Validations Could Have Identified Unassigned Cases

The IRM² requires an annual match of Collection function cases using Entity Mismatch Reports for all districts that do not use the ICS for case management.

² IRM Handbook 5.3 - SubSection 1.2.5 and Handbook 114.1 - Subsection 4.4.3.1.

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Five percent of Collection inventories in seven former districts were associated with questionable assignment codes.

The Transition Template noted that changes to management information systems might not be completed until January 2002 but that “inventory control will remain the same.” The seven former districts we reviewed converted to the ICS prior to the transition.

Inventory validations were not conducted in the seven former districts we reviewed. Although not specifically required for districts that used the ICS, inventory validations could have identified that the November and December 2000 ICS inventory reports listed 78 (5 percent) out of 1,600 possible assignment codes that were not assigned to current employees. Of these 78 codes:

- Thirty-eight (49 percent) were assigned to vacant positions.
- Twelve (15 percent) were assigned to hold files.
- Twenty-eight (36 percent) were assigned to other non-employee-related classifications, such as monitoring installment agreements.

Assigned to the 78 non-employee codes were 3,712 field Collection cases, which is 5 percent of the total of 71,008 cases. Of these 3,712 cases, 1,963 (53 percent) were assigned to the hold file codes and 750 (20 percent) were assigned to vacant position codes. The cases assigned to vacant positions are at the greatest risk of being overlooked and not resolved timely. The 3,712 cases ranged in age from “current” status to more than a year old.

Managers in former districts believed inventory validations were unnecessary because many of their employees were not affected by the organizational realignment.

Collection function managers interpreted the validation requirements differently, which affected their decisions not to validate their inventories. Just as with Examination cases, some managers in the former districts believed Collection inventory validations were unnecessary because many of their employees were not affected by the organizational realignment. The SB/SE Division’s Compliance Policy management stated that physical validations of Collection case inventories are no longer necessary because inventory management is now automated. However, Collection function

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managers and stand-down teams could have made better use of the available resources, such as using routine error and mismatch reports during management reviews prior to the transition.

Mismatches or misassigned cases can delay resolution, which negatively affects taxpayer rights because delays add additional interest to the outstanding tax balance. Mismatches can also distort case-related management information data used by new organizational managers.

During our review, we informally provided the results of our assignment code analysis and employee inventory matches to applicable Collection function managers, to assist them in resolving these issues.

Conclusion

The SB/SE Division needs to address and resolve pre-existing inventory-related concerns.

While the transition of Examination and Collection function processes to the new SB/SE Division was generally effective in maintaining basic processes, opportunities exist to improve case inventory management.

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Appendix I

Major Contributors to This Report

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Appendix II

Report Distribution List

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Audit Liaison: Commissioner, Small Business/Self-Employed Division S:COM

Glossary of Terms

The **Audit Information Management System (AIMS)** is a computer system designed to give the Examination function information about tax returns which are selected for examinations, and whether they are open (in process) or closed (the examination is complete).

Cases or case files are composed of one or more taxpayer returns, correspondence, other documents, or assessments.

Compliance Area and Territory Offices are the new geographic locations of Compliance field operations (16 Areas and 177 Territories), which replaced the 35 former district locations.

Compliance function is the term used to describe the combined former Examination and Collection divisions.

Entity is an automated Collection function system that provides for case-related time reporting and other management information.

The **Examination Returns Control System (ERCS)** is an automated inventory management system used for controlling tax returns and technical time charges from the time tax returns arrive in the Examination function until they are closed.

The **ERCS Dropped AIMS Record Report** lists records that are open on the ERCS but are not open on the AIMS.

Hold files contain cases which managers have not yet assigned to employees.

The **Integrated Collection System (ICS)** is an automated inventory system used by Collection function employees to report case time and activity.

The **ICS Current Inventory Report** is a summary report that lists cases assigned to Collection function employees.

The **Integrated Data Retrieval System (IDRS)** is a computer system that provides IRS employees visual access to taxpayer accounts.

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The **Masterfile** is the Internal Revenue Service's (IRS) main computer system; it contains information about all taxpayer returns and related documents.

The Collection function uses unique four-digit **numeric codes** to assign casework to individual employees, organizational units, or sub-organizational units.

Stand-down is a term the IRS uses to denote the end of its former geographic-based field organization.

Stand-up is the term the IRS uses to denote the start date of its new operating divisions.

Validation means to confirm the accuracy of the physical and electronic inventories of taxpayer cases assigned to Compliance function employees.